VZCZCXRO5978
PP RUEHAG RUEHAST RUEHDA RUEHDF RUEHFL RUEHIK RUEHKW RUEHLA RUEHLN
RUEHLZ RUEHPOD RUEHROV RUEHSR RUEHVK RUEHYG
DE RUEHBM #0562/01 1960543
ZNR UUUUU ZZH
P 140543Z JUL 08
FM AMEMBASSY BUCHAREST
TO RUEHC/SECSTATE WASHDC PRIORITY 8484
INFO RUEHZL/EUROPEAN POLITICAL COLLECTIVE
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC

UNCLAS SECTION 01 OF 02 BUCHAREST 000562

STATE FOR EUR/NCE, EB/IFD
TREASURY FOR LKOHLER
COMMERCE FOR ITA BURGESS/KIMBALL/NAJDI

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: EFIN ECON ETRD EIND RO
SUBJECT: ROMANIA: CENTRAL BANK ON CREDIT MARKETS, INFLATION AND
EXTERNAL DEFICIT WORRIES

SENSITIVE BUT UNCLASSIFIED - NOT FOR INTERNET DISTRIBUTION

¶1. (SBU) Summary. At a June 27 roundtable to discuss the Romanian central bank's (BNR) stance on credit growth and its impact on other economic fundamentals, BNR Governor Mugur Isarescu stressed that BNR's recent tighter monetary policy does not aim to stop non-government credit growth, but instead to encourage a normal weight of such credit as a percentage of GDP. In Romania non-government credit outstanding is nearing 40% of GDP, still far below the EU-15 average of nearly 100%, which still allows significant room to grow. However, the BNR Governor remains worried that the present non-government credit growth rate is too high, posing risks for financial stability in light of Romania's above-target inflation rate and large external deficit. End summary.

¶2. (SBU) BNR Governor Mugur Isarescu hosted a roundtable on June 27 to discuss BNR's views on non-government credit growth in relation to the current account deficit, inflation, and economic growth. Participants included BNR officials, commercial bankers, and managers from top auditing firms and the stock exchange. In his keynote presentation, Isarescu stressed that from a macro-economic perspective, BNR is interested in both price stability and the financial stability of commercial banks and non-banking financial institutions. With regard to price stability, the BNR is trying to bring inflation back under control with (he insisted) the support of the Government of Romania (GOR) from a budgetary standpoint. However, in his opinion, the recent surge in inflation has for the most part been caused by exogenous factors, including poor performance by Romania's agricultural sector in 2007 coupled with continued high demand for foodstuffs. He explained the latest hike in interest rates by stating his hope that this will reduce demand for credit, while at the same time encouraging savings through higher commercial bank interest rates. (Note: the BNR recently raised short term rates by 2.5 basis points to 10 percent.)

¶3. (SBU) With regard to financial stability, commercial banks are generally in good shape, but anecdotal evidence indicates that credit may be growing faster than the capacity of banks to manage the risk of nonperforming loans. According to Isarescu, one early warning signal is that some commercial banks have purportedly been granting loans simply for households to cover regular utility bills. Not only is this an inappropriate use of credit, it is also a sign that rising prices are straining household budgets. Isarescu warned that this behavior will increase the level of uncollectible debt on the books of commercial banks in the event of an economic slowdown. Additional concerns include greater risk to banks from increasingly sophisticated counterfeiting of personal identity documents in order to prove income on loan applications; this counterfeiting has become a closet industry in some Romanian counties. In addition, the risk of default is concentrated in the relatively small number of households, primarily in major cities, able to access commercial

credit. Many households, especially in rural areas, still remain underserved. According to Isarescu, expanding banking services into rural areas would decrease risk, both by reaching new businesses and households and by offering credit securitized against real property assets.

¶4. (SBU) Beyond its inflation worries, the BNR believes Romania faces economic challenges connected to the level of the external deficit and risks from a fluctuating foreign exchange rate. Of these, Isarescu considers the external deficit to be the bigger problem. While it is possible that the size of the deficit relative to GDP is exaggerated due to underreporting of GDP, at almost 14% of GDP it still is too large. According to the central bank, a current account deficit of this size is unsustainable in the medium to long term. The goal is to bring it down gradually to a more sustainable 7-10% of the GDP, at which level foreign direct investment inflows can be expected largely to cover the deficit.

¶5. (SBU) While international financial markets as a whole are experiencing a shortage of liquidity, Isarescu believes there are no serious short-term liquidity concerns for Romania. He reiterated his opinion that the Leu was overvalued for most of 2007, a verbal cue that BNR is cautious about increasing the Leu benchmark interest rate any further out of fear that a higher spread between Leu and Euro rates will fuel speculative capital inflows. However, this reluctance to hike interest rates beyond the current level could begin to impact negatively the BNR's ability to influence inflationary expectations, if inflation does not begin to moderate soon.

¶6. (SBU) Comment. One of the reasons why Romania's financial markets and non-government credit growth have been little affected by international market turmoil is that, unlike some other EU member

countries experiencing high current account deficits, Romania has a competitive banking sector which is not captive to a handful of foreign banks. Another factor that has assisted the local market in avoiding the sub-prime mortgage problems seen in the U.S. and some parts of Europe is that in Romania, only 20% of total non-government credit is in mortgages, whereas housing loans average 70% of non-government loans in the rest of the EU. The BNR Governor used the opportunity of this workshop to publicly advocate for tighter lending and a more balanced external deficit as ways to mitigate possible economic over-heating and inflation. At the same time, commercial bankers are still hungry for market share, making restrictions a harder sell. While the rate of increase in inflation may slow down this year, the BNR is unlikely to achieve its "price stability" goal of keeping inflation within the target ceiling. End comment.

TAPLIN